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Written Testimony
Comptroller Kevin Lembo
April 23, 2015

Concerning

SB 1135 An Act Establishing a Sustainable Path for Maintaining the Budget Reserve Fund and Reducing the Effect of Revenue Volatility on the State Budget.

Senator Fonfara, Representative Berger, Senator Frantz, Representative Davis and Members of the Committee:

Thank you for the opportunity to express my support for *Senate Bill 1135 An Act Establishing a Sustainable Path for Maintaining the Budget Reserve Fund and Reducing the Effect of Revenue Volatility on the State Budget.*

I would also like to thank Senator Fonfara for his leadership and work on this issue; as well as Representative Candelora for his continual legislative efforts related to the Budget Reserve Fund (BRF).

As you already know, Connecticut's high concentrations of individual wealth and significant number of corporate headquarters result in large fluctuations in revenue as economic conditions change. Revenue fluctuations result in significant revenue shortfalls when the economy is under-performing, requiring cuts in programs, reductions in aid to cities and towns, tax increases or all of the above.

The BRF also known as the Rainy Day Fund, can be used as an important tool for stabilizing the state's revenue stream to protect against large fluctuations in revenue.

This bill allows the state to fully realize the potential of the BRF as a mechanism to protect against revenue losses during economic downturns by increasing the cap on the BRF balance and making deposits into the fund a higher budgetary priority during good economic times.

(more)

Currently, deposits are made to the BRF at the close of the fiscal year with any unappropriated surplus being transferred to the BRF. Historically, this mechanism has resulted in limited deposits into the BRF. Anticipated surpluses have often been appropriated for other purposes during the budget process. In fact, since 1992, Connecticut has realized a total of $8.7 billion more in General Fund revenue than originally budgeted in years in which revenue outperformed expectations. However, of this excess revenue less than one third, $2.5 billion, has been deposited into the BRF[1]with the remainder used for other purposes.

The lack of consistent funding of the BRF resulted in insufficient balances for the state to weather either of the last two economic recessions. During the 2002 recession, General Fund tax revenue was $1.4 billion below 2001 levels over a two year period. In 2009, General Fund tax revenue took three years to recover to 2008 levels and shortfalls totaled $3.9 billion.[2] BRF balances were entirely insufficient to cover the revenue shortfalls of either recession. In 200 the BRF balance was $595 million and in 2008 the balance was $1.4 billion.[3] These inadequate reserve balances required cuts in services and increases in taxes in order to balance the state budget. Higher taxes and fewer government services placed additional downward pressure on the state's economy at the worst possible time. Greater BRF balances would have reduced or eliminated the need for such draconian measures.

To ensure better budgeting results in the future, SB 1135 makes BRF deposits a higher budgetary priority. It seeks to put Connecticut's budget on a more sustainable path by instituting a new formula to calculate required BRF deposits. The formula requires automatic deposits to the BRF each time the state's two most volatile major tax revenue sources, the estimated and final payments portion of the income tax, and the corporations tax, over perform in comparison to historical norms. Projected required deposits would be identified prior to the start of the legislative session and deposited into a special account outside of the General Fund. Identifying the projected deposits early will reduce the temptation of future legislators to re-appropriate the funds before they are certified as surplus by the Comptroller at the close of the fiscal year. But the bill is sensitive to abrupt changes in fiscal conditions by including provisions to return monies set aside for BRF deposit to the General Fund should revenue projections decline.

Placing a higher priority on BRF deposits will allow the state to build larger BRF balances prior to the next recession. However, the current statutory limit on BRF balances may be too low to provide adequate protection against declines in tax revenue associated with the next economic

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[1] See exhibit 1 attached for further detail
[2] See exhibit 2 attached for further detail
[3] Annual Report of the Comptroller - Budgetary Basis 2001, 2008

downturn. Current statute sets a cap on BRF balances of 10 percent of General Fund appropriations. Each of the last two recessions resulted in reductions in General Fund tax revenue of greater than 10 percent of net General Fund appropriations. In order for the BRF to act as a stop gap while tax revenues are depressed from an economic downturn, this legislation raises the cap on BRF deposits from 10 percent to 15 percent of net General Fund appropriations. A 15 percent cap will allow the state to build more adequate reserves in the BRF and is in line with the latest recommendations of the Governmental Accounting Standards Board (GASB).

Finally, SB 1135 seeks to assist in paying down unfunded liabilities by directing a small portion of excess revenues as identified by the new BRF deposit formula toward unfunded liability payments.

Had the BRF deposit mechanism proposed in this bill been in place since the inception of the income tax in 1992, the state would have been in a significantly better position leading into each of the last two recessions. Moreover, unfunded liabilities would have been reduced by approximately $800 million.

Rainy Day Fund Balance: Actual vs. New Formula (1992-2015)

FY	*Actual Balance*	***New Deposit Formula Balance***
2001	$595M	***$1,573M***
2009	$1,382M	***$2,534M***
2015	$519M	***$262M***
Total:	**$2,496M**	***$4,368M***
Total Payment Toward Unfunded Liability 1992-2014	**$776M**	

The higher BRF balances would have significantly limited the need for program cuts and tax increases in each of the two recessions experienced over the analysis period. In the absence of adequate reserves the program cuts and tax increases that were experienced further contributed to economic instability.

The proposed BRF deposit formula in this legislation combined with the proposed increase in the cap on BRF balances will enable the state to better manage the swings in revenue collections by storing money away in good economic times so that it is available when the economy slumps. Higher BRF balances in the run up to the next recession will hasten the state's economic rebound and avoid a slower recovery. It will also help prevent cuts in programs and services at a time when they are most needed and tax increases when least affordable. Better management of the BRF means a brighter future for Connecticut.

Thank you to the committee for its work on this important issue. I urge your support.

Attachment

Exhibit 1:

Excess Revenue is defined as the difference between actual General Fund revenue collections and Budgeted Revenue. Graph only displays Fiscal Years in which actual revenue outperformed budgeted revenue.

Source: Comptroller's Annual Report on a Budgetary Basis 1990-2014, schedule B2.

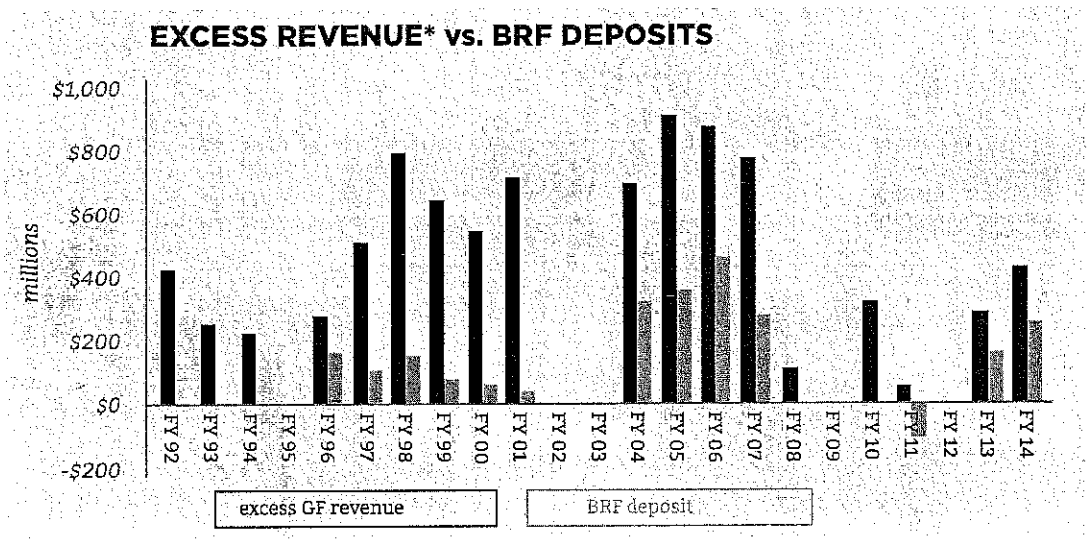


Exhibit 2:

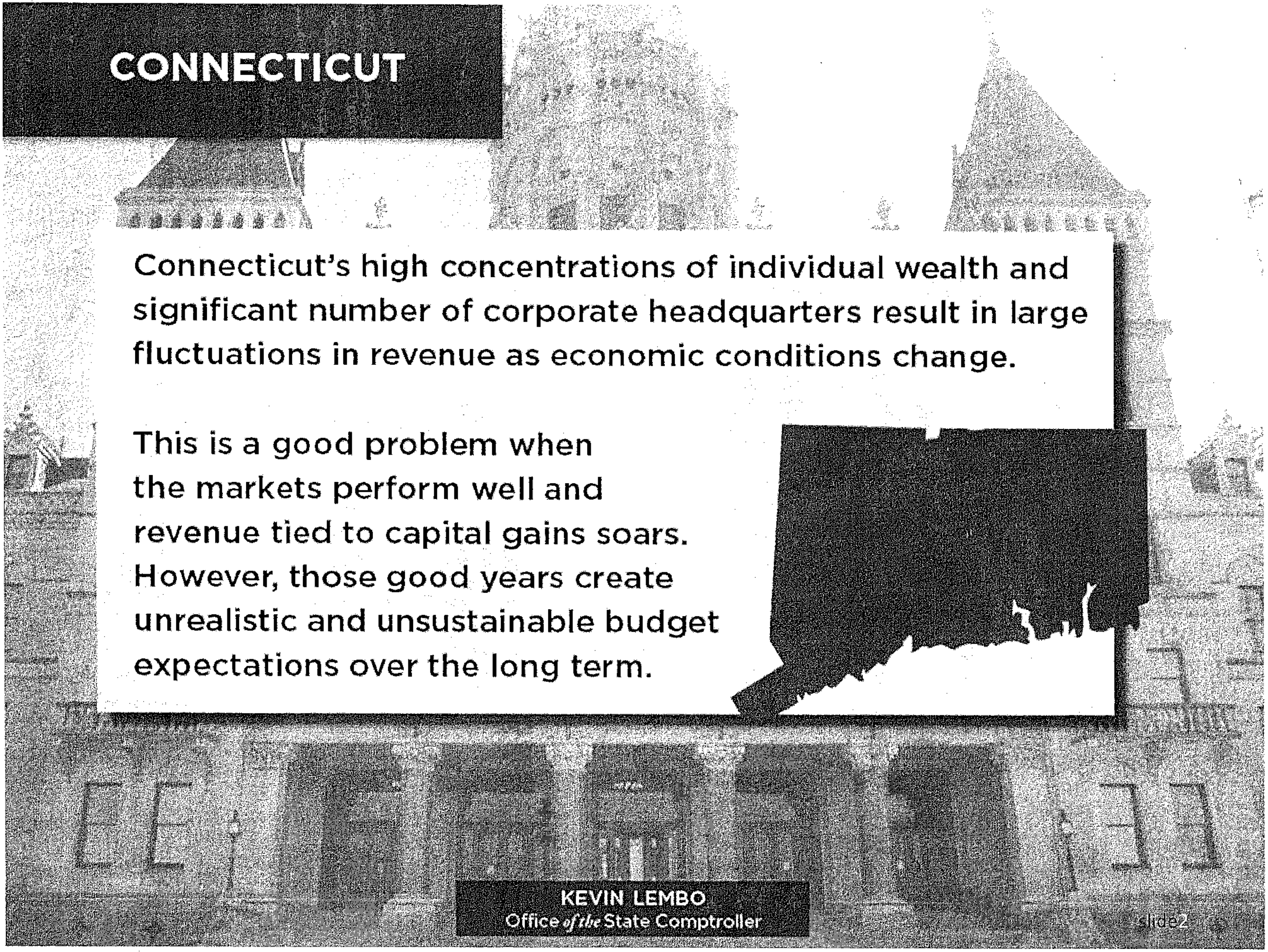
Revenue Shortfalls are defined as the difference between the total General Fund tax revenue the fiscal year immediately preceding a recession (base year) and revenue collection in the ensuing fiscal years in which total general fund tax revenues remains below the base year.

Source: Comptroller's Annual Report on a Budgetary Basis 2001-2003 & 2008-2011, schedule B2.

FY	General Fund Tax Revenue
2001	$8,707,093,316
2002	$7,730,953,705
2003	$8,229,806,746
2002 Recession Total Revenue Shortfall:	*$1,453,426,181*

FY	General Fund Tax Revenue
2008	$12,523,911,045
2009	$10,708,262,539
2010	$10,894,132,455
2011	$12,049,466,814
2009 Recession Total Revenue Shortfall:	*$3,919,871,327*


RAINY DAY FUND
STABILIZING CONNECTICUT'S REVENUE STREAM WITH THE BUDGET RESERVE FUND
KEVIN LEMBO
Office of the State Comptroller


CONNECTICUT
Connecticut's high concentrations of individual wealth and significant number of corporate headquarters result in large fluctuations in revenue as economic conditions change.
This is a good problem when the markets perform well and revenue tied to capital gains soars. However, those good years create unrealistic and unsustainable budget expectations over the long term.
KEVIN LEMBO
Office of the State Comptroller
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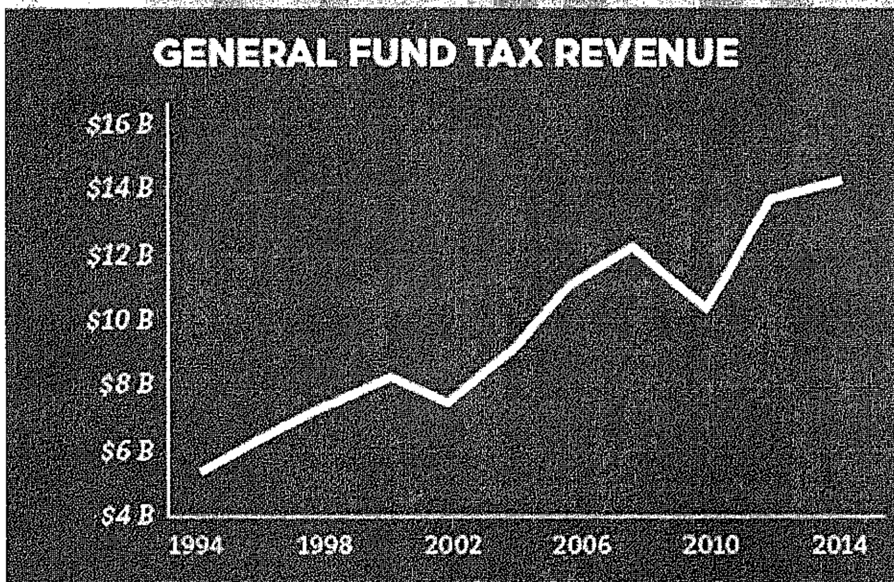
BOOM & BUST

Connecticut has been riding a revenue roller coaster for decades – building budgets through sharp boom-and-bust economic cycles.



THE PROBLEM

Budget promises can turn into false promises when booms turn into busts.

The busts result in sharp and significant revenue shortfalls, requiring cuts in programs, reductions in aid to cities and towns, tax increases or all of the above.

The boom-and-bust cycles are getting shorter, more frequent and more difficult to weather.

KEVIN LEMBO
Office of the State Comptroller

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THE BUDGET RESERVE FUND

We propose reforming the state's Budget Reserve Fund – commonly known as the "Rainy Day Fund."

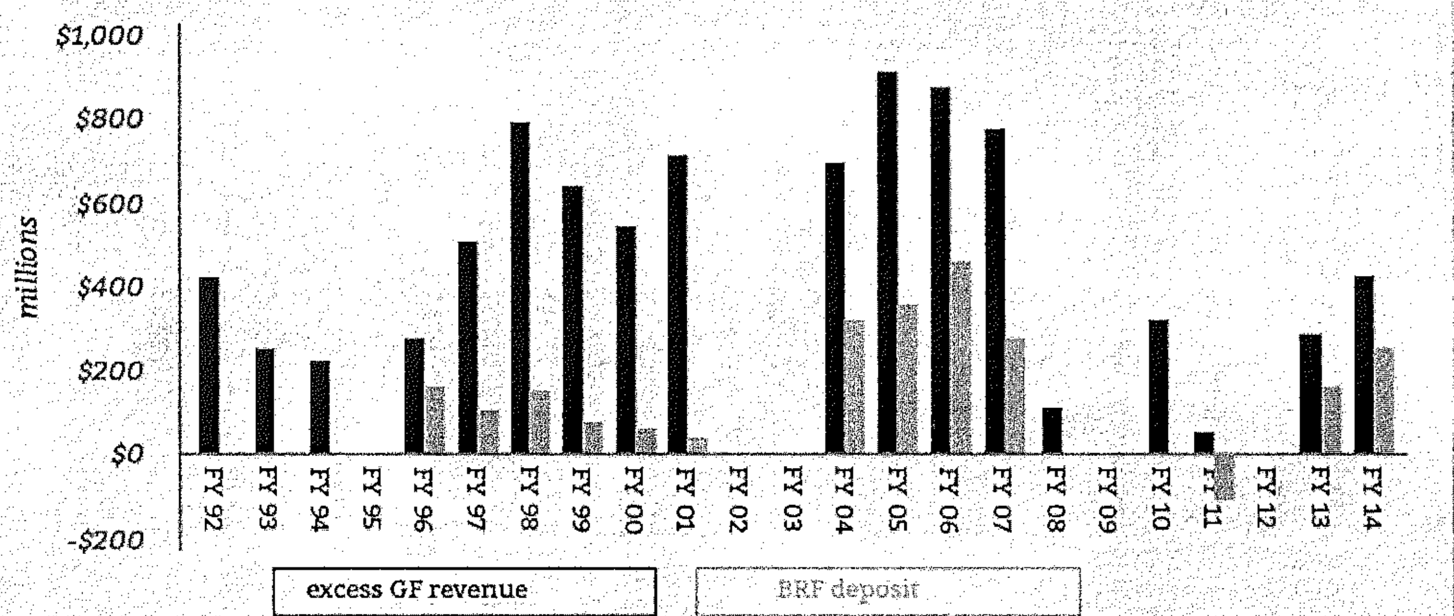
The Budget Reserve Fund can be used to stabilize the state's revenue stream by putting money away during strong economic growth that can then be used to stabilize the state budget in economic downturns.

CURRENT PRACTICE

Currently, the state only makes deposits into the Budget Reserve Fund when there is a surplus not set aside for another purpose.

Since 1992, in years in which revenue outperformed expectations, less than one third has been deposited into the Budget Reserve Fund.

EXCESS REVENUE* vs. BRF DEPOSITS



* Excess Revenue is defined as the difference between actual General Fund revenue collections and Budgeted Revenue. Graph only displays Fiscal Years in which actual revenue outperformed budgeted revenue.

Source: Comptroller's Annual Report on a Budgetary Basis 1990-2014, schedule B2.

INADEQUATE DEPOSITS

Due to the state's inconsistent saving, reserves have been inadequate to fill revenue shortfalls in the past two recessions:

Recession FY	Actual BRF Balance	Total Revenue Shortfall*
2002	$595M	$1,453M
2009	$1,382M	$3,920M

*Revenue Shortfalls are defined as the difference between the total General Fund tax revenue the fiscal year immediately preceding a recession (base year) and revenue collection in the ensuing fiscal years in which total general fund tax revenues remains below the base year.

Source: Comptroller's Annual Report on a Budgetary Basis 2001-2003 & 2008-2011, schedule B2.

KEVIN LEMBO
Office *of the* State Comptroller

THE PROPOSAL

The fund could better manage revenue fluctuations if excess revenue from volatile tax streams were automatically deposited into the fund during periods of strong economic growth.

Two tax revenue streams that are particularly volatile due to the demographic and economic makeup of Connecticut are:

1. the estimated and final payments portion of the income tax
2. the corporation business tax

GUIDING PRINCIPLES

A proposal, now pending before the legislature's Finance Committee, would stabilize Connecticut's future budgets, manage state income volatility, reduce unfunded liabilities and put downward pressure on spending.

A new Budget Reserve Fund formula should meet the following goals:

- lower General Fund revenue volatility;
- retain the long-term revenue growth potential of revenue streams to which it is applied;
- require zero or minimal deposits immediately following a recession; and
- increase the BRF balance available to offset revenue declines during recessions.

OTHER CONSIDERATIONS

In order to have sufficient funds in the Budget Reserve Fund to stabilize the budget during an economic downturn, the cap on the Budget Reserve Fund balance should be raised from 10% to 15% of net General Fund appropriations.

The state also needs to prioritize paying down our unfunded liability. Any deposits to the Budget Reserve Fund should include a percentage of the deposit rerouted to pay down unfunded liability.

A PICTURE OF POSSIBILITY

Had Connecticut had a budget reserve fund deposit formula beginning in 1992 that automatically deposited excess revenue from the two identified volatile tax revenue streams, with part of the deposit going to pay down unfunded liability and a cap of 15% in place, reserves may have looked more like this:

BRF Balances - Assuming Deposits made according to formula 1992-2015

FY	*Actual BRF Balance*	*New Deposit Formula BRF Balance*
2001	$595M	*$1,573M*
2009	$1,382M	*$2,534M*
2015	$519M	*$262M*
Total:	**$2,496M**	***$4,368M***
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MORE INFORMATION

The Office of the State Comptroller welcomes your input and ideas on this proposal. We look forward to your support throughout the legislative process. If you would like more information or wish to discuss this issue further, please contact our legislative liaison, Jacqueline Kozin via email, Jacqueline.Kozin@ct.gov, or telephone, 860.702.3305.